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Cloudflare, Inc. (NET)

Q4 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Emma, and I will be your conference operator today. At this time, I would like to welcome everyone to the Cloudflare Q4 2021 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. In a matter of time, we ask that you limit yourself to one question and one follow-up. [Operator Instructions] Thank you.

Jayson Noland, you may begin your conference.

Jayson A. Noland

Head-Investor Relations, Cloudflare, Inc.

Thank you for joining us to discuss Cloudflare's financial results for the fourth quarter 2021. With me on the call we have Matthew Prince, Co-Founder and CEO; Michelle Zatlyn, Co-Founder, President and COO; and Thomas Seifert, CFO. By now, everyone should have access to our earnings announcement. This announcement, as well as our supplemental financial information, may be found on our Investor Relations website.

As a reminder, we'll be making forward-looking statements during today's discussion, including but not limited to our customers, vendors and partners' operations and future financial performance; anticipated product launches and the timing and market potential of those products; the company's anticipated future revenue, financial performance, operating performance, non-GAAP gross margin, non-GAAP net income, non-GAAP net income per share, shares outstanding, non-GAAP operating expenses, free cash flow, non-GAAP tax expense, dollar-based net retention rate, paying customers, and large customers.

These statements and other comments are not guarantees of future performance but rather are subject to risks and uncertainty, some of which are beyond our control, including but not limited to the extent and duration of the impact of the COVID-19 pandemic and adverse conditions in the general domestic and global economic markets. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. These forward-looking statements apply as of today and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after this call. For a more complete discussion of the risks and uncertainties that could impact our future operating results and financial condition, please see our filings with the Securities and Exchange Commission, as well as in today's earnings press release.

Unless otherwise noted, all numbers we talk about today, other than revenue, will be on an adjusted non-GAAP basis. All current and prior period financials discussed are reflected under ASC 606. You may find the reconciliation of GAAP to non-GAAP financial measures in our earnings release on our Investor Relations website. For historical periods, a GAAP to non-GAAP reconciliation can be found in the supplemental financial information referenced a few moments ago.

We would also like to inform you that we will be participating in the JMP Securities Technology Conference on March 7, the KeyBanc Emerging Technology Summit on March 8, and the Morgan Stanley Technology, Media and Telecom Conference on March 9.

Now, I'd like to turn the call over to Matthew.

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

Thank you, Jayson.

In the immortal words of Bill and Ted, we had a most excellent quarter. In Q4, we achieved revenue of \$194 million, up 54% year-over-year. We added 156 new large customers, those that spend more than \$100,000 a year with us, ending the year with 1,416 large customers, up 71% year-over-year. Our dollar-based net retention ticked up to a record 125%, improving 6 percentage points from a year ago.

For the full year, we earned \$656 million, up 52% year-over-year. 2021 becomes our fifth straight year with 50% or greater compounded growth. I'm proud of two things. First, over those five years, our growth has actually accelerated. But second, and probably more important, our growth has been relentlessly consistent. We've dialed in our business, we understand and are in control of its levers. You can see that in metrics like our gross margin. While talk across the industry is about increasing costs and pricing pressure, we achieved a gross margin of 79%. That remains above our long-term target gross margin range of 75% to 77% and creates some opportunity. We expect to use this exceptional gross margin as a weapon to take business from competitors more vulnerable than we are to pricing and cost pressures. It also allows us to bundle together products into an overall platform no competitor can match.

In Q3, we had our first quarter as a public company with positive operating margins. This is our second. It won't be our last. That said, as I talked about last quarter, we are not in a rush to be significantly profitable. Over the years, our team has asked me about profitability. The story I told them was to imagine every year you saw your neighbor shoveling money into a machine. A year later, a lot more money came out. Year after year, the money kept piling up and getting shoveled back in. If one year, you look out your window and didn't see your neighbor shoveling all the money back into the machine, you'd worry. What's wrong with the machine? To be clear, there is nothing wrong with our machine. We will continue to shovel money back in to drive innovation and reach new customers as long as we can achieve exceptional growth. We think of managing our operating margin a bit like

that game Flappy Bird, not too high, not too low. For long as we can, we want our operating margin to hold just about breakeven and right where it's been for the last two quarters. In other words, we've done something wrong if we beat significantly on EPS.

Cash flow on the other hand, nobody is going to complain if there's more cash in your bank account at the end of the quarter than there was at the beginning. We're proud that this is Cloudflare's first quarter since we've been public to be free cash flow positive. It also won't be our last. We know this is a business that can generate significant cash flows when we want. In the short term, we expect we'll see negative cash flows in the next two quarters as we invest in our network and redesign our physical offices for a post-COVID world. But by the second half of the year, we forecast we'd be free cash flow positive. We admire and seek to emulate other companies that came before us and had significant cash flows while holding operating margins at breakeven, and we feel very dialed in and confident in our business as we come out of the uncertainty of the last two years.

So, what's our secret? It's not one thing, it's many. It starts with innovation. When we talk to customers, what they appreciate about Cloudflare is our relentless innovation. It expands our market and ensures that customers can use us to be the complete future of their corporate network. But beyond new products, we leverage economies of scale and network effects to drive our business and innovate more efficiently.

Yes, the supply chain has gotten harder, but we've leveraged our relationship, hyperefficient procurement team and fully software-defined network to keep driving our costs down. Network effects are spawned by networks, and we run one of the largest networks in the world. As customers join our network, our network gets better and more efficient. If you want to understand how we've been able to continue to drive our business at this rate, this virtual cycle is where to look.

And because it's a flywheel, this efficiency allows us to continue to invest in products. Our team loved launching new products, and we're planning at least seven innovation weeks full of new products in 2022, further extending our network, introducing new capabilities, and growing our TAM.

The products we announced in 2021 are already thriving. For example, we had over 200,000 domain signups for our email writing service, and seemingly overnight had become a major email security provider. R2, our zero egress object store, has had more than 9,000 signups for its closed beta, including some incredible logos. They represent hundreds of petabytes of storage and demonstrate the palpable excitement around our Workers developer platform. We're on track for R2 to progress to open beta in Q2 and then be generally available in the second half of 2022.

While our bias is toward internal product development, we will make strategic acquisitions when we find teams and products that can complement what we've built. I'm excited to announce today that we've acquired Vectrix, a start-up that has built the easiest-to-use, most powerful CASB we've seen. CASBs, cloud access security brokers, are a category of services that give visibility and control over data stored in SaaS applications. They can be powerful tools, but their Achilles heel has always been their complex setup. The Vectrix team impressed us with how quickly they could onboard any new customer regardless of size, and instantly give them visibility into all the service providers where the customer's data was stored. As such, their product is a natural add-on to every current Cloudflare customer.

They remind me of Cloudflare and our philosophy since our earliest days. The Vectrix team and technology further rounds out our Zero Trust platform, giving visibility not only for data flowing across the network, but now also data at rest in service providers. We believe it makes Cloudflare Zero Trust a no-brainer comprehensive security solution for any company, and we're thrilled to have the Vectrix team on board.

Let me highlight some great wins we had with Zero Trust and other products in the quarter. A global Fortune 500 telecommunications company signed a \$1 million annual contract for over 100,000 Zero Trust seats. This customer initially started on a self-service plan with fewer than 500 seats two years ago. This win shows how the ease of use of our service and ability to land customers with individual teams within organizations can efficiently turn them into major customers over time.

A Fortune 500 media company signed a \$250,000 annual contract for more than 10,000 Zero Trust seats. It was a competitive deal, but ultimately they selected us for being the most flexible and innovative solution on the market.

What's great about wins like these is that there's an opportunity for us to expand the customers across our entire platform. You earn your place on the platform one feature at a time. Customers often work with us to solve a problem, and then over time give us the chance to compete for more of their business. And we saw exactly that with other customers this quarter.

For instance, a Fortune 500 financial services company expanded their use of our platform by signing a \$900,000 three-year expansion deal, bringing their annual contract value to over \$1.5 million. They described it as "future proof". It's an example of us bundling our platform to give them access to a broad set of our features while minimizing procurement friction.

A Fortune 1000 shipping and logistics companies signed a similar platform bundle deal, which more than doubles their three-year contract value to \$3 million. They specifically appreciated how Cloudflare was a single vendor they could turn to deliver the future of their corporate network.

A Fortune 500 pharmaceutical company signed a \$750,000 three-year deal for network security. It continues to be true that as companies migrate their on-premise hardware solution, they continue to turn to Cloudflare to build the future of their networks. And as we come out the other side of COVID, we're seeing more and more companies rethink their network design and moving to the cloud and away from on-premise boxes.

A Fortune 500 retailer moved away from two competitors in order to take advantage of Cloudflare Workers. While the competitors had promised similar functionality, they found it simply didn't work as promised. They signed a three-year \$1.2 million contract. Our Workers platform, which has been in production now for four-and-a-half years continues to extend its lead with developers.

And you didn't have to be a Fortune 500 company to sign a big deal with us this quarter. One of the most innovative payment start-ups signed a three-year \$1.5 million contract for our network security products. They appreciate Cloudflare Workers and the flexibility it provided them to service a broad set of merchants worldwide.

Finally, in our business, we need to stay on top of cybersecurity issues globally. We are therefore watching the situation in Ukraine closely. Modern warfare increasingly includes the cyber battlefield. While they don't generate meaningful revenue, we have onboarded a number of Ukrainian businesses, news outlets, and government organizations in anticipation of potential attacks. While we hope the current tensions will resolve peacefully, we have experience mitigating nation state cyberattacks and we are prepared to defend our customers and network whatever may come.

Before I turn it over to Thomas, I wanted to thank the entire Cloudflare team for all your hard work and dedication. It was a most outstanding quarter and most outstanding year. I'm excited for what we're going to achieve together in 2022. And with that, Thomas, take it away.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thank you to everyone for joining us. We delivered another excellent quarter and wrapped up an incredible year. In 2021, we achieved multiple records and milestones and ended the year with accelerated revenue growth. Large customer additions continued to outpace top line revenue growth, and we achieved a record 125% dollar-based net retention rate in the fourth quarter.

We continue deliver over 50% compound annual growth rate on revenue since 2016 and remained profitable since the third quarter. These achievements reinforce our track record of delivering strong revenue growth at scale, with increasingly strong unit economics benefiting from the inherent strength of our business.

Turning to revenue, total revenue for the fourth quarter increased 54% year-over-year to \$193.6 million. The growth in revenue was driven by another quarter of strong customer demand, both in terms of new logo acquisition, as well as expansion within our existing customer base. We ended the fiscal year with a revenue of \$656.4 million, representing an increase of 52% year-over-year. As I just mentioned, this makes it our fifth year of delivering at least 50% compound annual growth rate on revenues since 2016, a testament to the consistency and durability of our business model.

From a geographic perspective, in Q4, we saw continued strength in both the US and internationally. The US represented 52% of revenue and increased 52% year-over-year. EMEA represented 27% of revenue and increased 60% year-over-year. APAC represented 14% of revenue and increased 29% year-over-year. We are pleased to see growth accelerate in APAC and see EMEA repeat as our highest growth geography. EMEA continues to benefit from a number of Data Localization Suite wins, driven by the increasing focus on GDPR and data privacy regulations.

Turning to our customer metrics, we exited the quarter with 140,096 paying customers, representing an increase of 26% year-over-year. We ended the year with 1,416 large customers, representing an increase of 71% year-over-year. We added 156 large customers in the quarter and 588 large customers in the fiscal year.

We're also providing an annual update on a few key large customer metrics, including large customer revenue contributions. Our large customers have not only grown the numbers but also their average spent with us, causing their revenue contribution to continue to climb through the year. For fiscal 2021, large customers represented 54% of total revenue compared to 46% of total revenue in 2020.

For the full year, we're also breaking out our large customers into cohorts of those who spend greater than \$500,000 and \$1 million. We ended the year with 121 customers that spend over \$500,000 with us, a 70% increase year-over-year. We ended the year with 56 customers that spend over \$1 million with us, a 75% increase year-over-year. The significant expansion from our large customers contributed to a record dollar-based net retention rate of 125%, representing an increase of 100 basis points sequentially.

We continue to see broad-based strength across our customer base and robust traction and growth in our large customer cohorts, which continues to outpace top line revenue growth. Gross retention remains over 90% and customer expansion continues to be fueled by compelling unit economics and increasingly favorable customer

acquisition cost. We will keep investing heavily in building our enterprise portfolio and developing a world class go-to-market strategy to position us for the massive opportunity ahead.

Moving to gross margin, fourth quarter gross margin was 79.2%, consistent with last quarter. Network CapEx represented 10% of revenue in the fourth quarter. In 2021, we added roughly 29,000 paying customers, representing an increase of 26% year-over-year. Traffic volumes have also increased significantly. In the fourth quarter, traffic volumes grew by 88% compared to the same quarter last year.

Despite these significant increases, we were able to maintain network CapEx as a percentage of revenue at 11% and a high gross margin of 78.6% for fiscal 2021. This underscores the resiliency of our network and our ability to use gross margin as a strategic weapon to gain market share. Going forward, we plan to accelerate investments in our global network and expect network CapEx to be 12% to 14% of revenue for fiscal 2022.

Turning to operating expenses, fourth quarter operating expenses as a percentage of revenue was flat sequentially and decreased 4% year-over-year to 78%. We had another strong hiring quarter where we saw our total number of employees increase 36% year-over-year, bringing our total number of employees to approximately 2,440 at the end of the quarter.

Sales and marketing expenses were \$86 million for the quarter. Sales and marketing as a percentage of revenue decreased 1% sequentially and decreased to 44% from 46% in the same quarter last year. Research and development expenses were \$37 million in the quarter. R&D as a percentage of revenue stayed flat sequentially and decreased from 19% from 20% in the same quarter last year.

General and administrative expenses were \$28 million for the quarter. G&A as a percentage of revenue stayed flat sequentially and decreased to 14% from 16% in the same quarter last year.

We saw continued operating leverage in the fourth quarter, with operating margins improving 550 basis points year-over-year. Operating income was \$2.2 million compared to an operating loss of \$5.5 million in the same period last year.

Q4 was our second consecutive quarter of achieving operating profit and as a reminder, we intend to grow our operating expenses in line with revenue to stay near or at breakeven and reinvest excess profitability back into the business to address the enormous opportunity in front of us.

Turning to net income and the balance sheet, our net income in the quarter was \$131,000 or net income per share of \$0.00. Tax expenses for the fourth quarter was \$1.9 million. We ended the fourth quarter with \$1.8 billion in cash, cash equivalents and available-for-sale securities. Free cash flow was \$8.6 million or 4% of revenue compared to negative \$23.5 million or 19% of revenue in the same period last year.

Operating cash flow was \$40.6 million in the fourth quarter or 21% of revenue. This represented an increase of \$47.5 million sequentially and an increase of \$49.4 million year-over-year, helped by strong cash collection and growth of new and existing business. We are very pleased to have achieved our first free cash flow positive report as a public company. Going forward, we expect to see some variability in the first half of 2022 as we continue to invest in building refurbishments and network capacity but we do expect to return to positive free cash flow in the second half of 2022.

Remaining performance obligations or RPO came in at \$624 million, representing an increase of 14% sequentially and 63% year-over-year. Current RPO was 77% of total RPO.

The strength we saw in the fourth quarter across top line, bottom line, and RPO, in combination with our rate of innovation that allows us to continuously expand TAM, gives us confidence and visibility heading into the new year.

For the first quarter, we expect revenue in the range of \$205 million to \$206 million, representing an increase of 48% to 49% year-over-year. We expect operating income to be in the range of \$500,000 to \$1.5 million and we expect a net income per share of \$0.00 to \$0.01. Assuming approximately 348 million common shares outstanding, we expect tax expense of \$1.7 million.

For the full year 2022, we expect revenue in the range of \$927 million to \$931 million, representing an increase of 41% to 42% year-over-year. We expect operating income for the full year in the range of \$10 million to \$14 million, and we expect net income per share over that period in the range of \$0.03 to \$0.04. Assuming approximately 352 million common shares outstanding, we expect a tax expense of \$8 million.

In closing, it has been a remarkable year for Cloudflare as we finish our second full year as a publicly traded company. I would like to thank our customers, partners, and the community for their endless trust and support in us, and I want to thank all Cloudflare employees for their continued dedication to innovate and deliver and serving our customers and global community. We've built a culture of relentless innovation, powerful platform, and a successful go-to-market strategy grounded by an exceptionally efficient and durable business model. This positions Cloudflare at the forefront of a tremendous opportunity as the corporate network transitions to the cloud and developers line up to build on our edge.

In 2022, we'll continue to invest in innovative new products and expand our total addressable market by turning point solutions into features of our global network. I'm extremely proud of what we have accomplished and I'm excited for this year.

With that, I'd like to open up for questions. Operator, please poll for questions.

QUESTION AND ANSWER SECTION

Operator: At this time, I would like to remind everyone to limit themselves to one question and one follow-up. [Operator Instructions] Your first question today comes from the line of Phil Winslow with Credit Suisse. Your line is now open.

Philip Winslow

Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, thanks, guys. Congrats on a great – into a great year. Wanted to focus on two initiatives that were announced in the fall. First was the global backbone. Wondering if you could give us a sense for just the strategic thought behind building that out, sort of an overlay, so to speak, on top of the virtual backbone that you have in place we know Cloudflare for.

And then also just Cloudflare for Offices, how does that complement what you're doing on the global backbone side in terms of, call it, being the most global but also the most local?

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Phil, thanks for the question. We are always looking at our network and asking ourselves how can we make it faster, how can we make it more reliable, and how can we make it more efficient. And I think the backbone is one of the things that checks all three of those boxes.

We have enough traffic across our network that it is now more efficient for us, meaning it is less expensive for us to run over our own private connections than it is over the public Internet in many cases. On top of that, every time you add another provider and especially when you add a provider you have complete control over, that allows you to optimize for the performance and reliability. And with our own backbone, because we sit at both sides of that, we can actually do things that you can't do over the public Internet.

We can support larger packet sizes. We can actually support protocols that aren't supported across the standard Internet and that allows us to really live up to our mission of helping build what is literally a better Internet and give our customers an experience they can't find anywhere else.

In terms of Cloudflare for Offices, what we have heard from our customers is that as they want to take advantage of all of our different services, they want to be able to plug-in to us as easily as possible. And so we are trying to offer on-ramps to them to be able to get on to our network and take advantage of our Zero Trust offering, make sure that their offices are protected from attack, and make that as easy as just plugging in a patch cable.

One of the things that we saw in the second half of 2021 was a real increase in cyberattacks directed directly at the network offices. It used to be once upon a time that DDoS attacks only went after, for example, your corporate marketing website. Now that more and more people are relying on virtual desktops or relying on Zero Trust network initiatives, attackers are smart to that and know that they can cause more harm and therefore extract larger ransoms by going after the networks themselves.

If we can make it so that you as a – one of our customers, really never touches the public Internet, you go straight from your office and router there to ours, that isolates you from attackers. And so we think that that's something

that is extremely attractive, again, at checking all those boxes, being more cost-effective for us to run, being more reliable, being more performant, and in addition to that, really being more secure.

So I think those things all line up and again, I think we've seen, especially with Cloudflare for Offices, early success in terms of adoption and it's somewhere that we continue to invest in and we're very excited about.

Philip Winslow

Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thanks. And then a quick follow-up for Thomas. Obviously, you continue to have success in larger deals with enterprises. When you look at the year, just the go-to-market motion, how are you feeling in terms of productivity and ramp time of the new hires and how are you thinking about that coming into this new year? Thanks.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Very optimistic. So we've seen that despite the growth we have seen over the last couple of years and despite the fact that we successfully move up the enterprise back to larger and larger customers with larger and larger ACVs, that we've been able not only to keep the productivity of the quota-carrying employees, but also the ramp curve. Getting them to productivity has not changed and our average sales cycle still continues to be under 90 days. So that's – when we talk about the durability and the consistency of the business model, that's one of the impressive vectors, that we have been able to keep those productivity levers despite the fact that the go-to-market motion has successfully migrated to larger and larger accounts.

Philip Winslow

Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thanks, guys. Keep up the great work.

Operator: Your next question comes from the line of Matt Hedberg with RBC Capital Markets. Your line is now open.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

Q

Oh, great. Thanks for taking my questions, guys, and I'll offer my congrats as well on a really strong year.

Matthew, you called out a lot of really exciting Workers deals this quarter, which is really good to see. I think it's one of the things that we all sort of are excited about longer term. Now, I'm wondering at this point, now that it's been out for a number of years, is there some way that you can help us understand maybe usage trends or penetration of Workers in your base?

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Matt, we are extremely excited about how Workers is being adopted across our customer base. We still see that north of 20% of new enterprise deals include Workers at some level. But I think what's even more exciting is that as we go downmarket and look at individual developers because people who actually have their hands on keyboards are who are the most important, we see an enormous amount of excitement there.

So a couple of different things. I think that this is the year that we will pass through a critical milestone of developers, which is how do you get to 1 million developers that are using the Workers platform. We see a clear path to that over the course of 2022 and I think that that's going to be a really exciting milestone for us.

I think the other piece is that we are starting to see companies that are being built entirely on Workers and so there was actually a startup company called Zaraz which was built entirely using Workers to optimize the marketing stack and build a much more secure, much more performant, and much more privacy-friendly sort of marketing, whether that's pixels or tags that are on Pages, built that in a way that was much more friendly. We met that team. They worked with us closely. They were incredibly helpful in giving us feedback and it was actually a company that we acquired two quarters ago.

Again, small team, not a meaningful bit but what I think is important there is that the developers of the future are betting their whole companies on Workers. Zaraz is not the only example of this. We see more and more companies that are starting with Workers as their development platform and the nature of development platforms is that they do create a flywheel where as developers build tools, as they build out an ecosystem, that makes it so more and more developers get involved.

And so we're excited about what's going on with Workers. We are continuing to invest in that and I think that whole team is just really thrilled with the adoption that we're seeing so far. And I think it's still early days but very exciting for both big customers and small.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

That's really good to hear. I think we're all excited about what that can do longer term. And then I guess as a follow-up, you guys had a great response to the Log4j security incident, I guess. Can you talk about sort of – could this be a positive demand driver for you all when we look to 2022 and beyond as people [ph] sort of (00:32:52) think first in the importance of your global network?

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

There are a couple things about that that were really interesting. The first is I think it's sometimes underappreciated, the scale of Cloudflare, what effectively is our sensor network. And so we were able to, after the Log4j vulnerability was reported, look back across our network which is comprised of millions and millions of sites with a huge diversity in terms of geography, in terms of size and scale, and we were able to see some of the very first exploits of that.

What's interesting about that is it turned out – in fact, we had the data that was two days before anyone else that was out there and it turned out that we actually caught the researchers themselves testing the vulnerability and we're able to see exactly how that was the case. So I think our ability to see what is going on live on the Internet is really – the diversity of the traffic gives us visibility into things that just comes earlier and allows us to react faster.

I think the second bit is that because of the way that we have worked with the research community, we're a very trusted partner in that space. And so we got early warning of the attack and we were able to very quickly react to be able to protect our customers. And I think that that ability to react quickly is not only a factor of having the information, but then having a programmable platform which, again, Workers is at the heart of, that allows us to very quickly adapt and roll out a response.

And we recognize that this was probably the worst vulnerability to come out in at least the last five years. And so we made the call to provide a level of protection even to our free customers because again, we think that building that goodwill amongst the larger community is the right thing to do, and that was very much recognized by our customers going forward.

I think over the longer term, this is the sort of vulnerability that really is the best evidence of why you need a Zero Trust platform. And the fact that we've got a platform that sees more than anyone else, that is more responsive than anyone else, that is more trusted in the security and research community than anyone else is able to react quickly and have as much goodwill in the community as anyone else, I think speaks extremely highly of our team, what we've built and our ability to continue to execute in the Zero Trust space. And so again, I think that these are the sorts of things that add up to winning in this space over time. People know that we're not just a fly-by-night security company that's a flash in the pan. They know that we're a good part and a good steward of the overall Internet ecosystem and what we hear from customers is they want to invest behind companies like that and I think that that's going to be a real tailwind for our Zero Trust business.

Matthew Hedberg

Analyst, RBC Capital Markets LLC



Thanks, Matthew. Well done, guys.

Operator: Your next question comes from the line of James Fish with Piper Sandler. Your line is now open.

James E. Fish

Analyst, Piper Sandler & Co.



Hey, guys, impressive quarter and guide there. Wanted to go back to Phil's question actually on Cloudflare for Offices. It was the solution that I think Matthew even highlighted could be the sleeper for 2022 versus kind of what else got announced during Speed and Birthday Weeks. And really just wanted to ask directly how the adoption and deployment of Cloudflare for Offices has been going and how that tails into kind of overall Cloudflare One adoption and getting to that Magic core plus solutions you guys like to see per customer.

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.



Yeah. I think the nature of the Offices product is that you have to install equipment in buildings around the world. And so right now, we are really focusing on those customers that are sort of the early examples of people who can use that. Those customers tend to be big Cloudflare adopters already. So a large Fortune 500 technology – consumer technology company uses us for a number of other things, wanted us to effectively become their corporate network. We prioritize them in terms of Cloudflare for Offices. We're learning quickly from what their adoption rate is and then we'll roll out based on that. A large international Fortune 500 mining company, again, large customer of Cloudflare already, was already running and a lot of their traffic through us was a natural addition for Cloudflare for Offices.

So I think what we will do is prioritize and what we have been doing is prioritize those customers where we have existing deployment and use. What's often the case, though, is that those customers are sharing some physical space in some of their offices with other customers and that starts to then create what is the target list for who are the next adopters of Cloudflare for Offices.

And so I think that it will roll out based more on demand and us building toward where customers are asking for it rather than us just deploying equipment and hoping for the best and I think that's the more sensible way of us doing it. What we have done, though, is secure all the technical infrastructure [ph] for (00:38:40) the right to be in the building that we think are the most important building and the connectivity to those building in order to be able to light up buildings as customers demand it.

So I think it's still a big piece of what's going on. I think it ties in a lot with our Magic Transit, Magic [indiscernible] (00:39:00) offering and then it's a great on-ramp for customers that are using our Zero Trust offering. And I still think it's going to be kind of one of the underfocused on but really – maybe underheralded but really important aspects of what we're building and we'll deliver in 2022.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Makes sense and appreciate that color. And you guys highlighted a lot of large wins this quarter, and it looks like the spending for these large net wins kind of ticked up quite a bit on top of moving into what it sounded like some more tier 1 kind of verticals like health care, telco, and financial services that it implies really your customer quality actually improved even within the large enterprise base that you guys talk about. And so not sure if this is Thomas or you, Matthew, but how are you guys feeling about the pipeline and extra reach into really the cream of the crop here of Fortune 500 customers in your 2022 guide?

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. You know what? It'd be interesting to look back over the last four quarters. But I think that that's actually been a trend that's been going on for quite some time. In financial services, health care, insurance, government, we've seen just increased penetration and a real understanding of what Cloudflare is doing. I think that the – our awareness in the market has ticked up measurably and we're able to use that.

And then the second piece is that as we land with a customer, then we're able to expand very quickly over time. Based on the broad set of products that we have, I think that we feel really good that a significant percentage of the Fortune 500 will use Cloudflare for something over the course of the next five years. What our real important challenge is, is to make sure that we get those customers to use us for as broad a set of our products and platform as possible. And I think that's actually the bit that really stood out for me this quarter was that we were seeing more and more of our large customers saying I want a site license to be able to – I'll commit to spending a certain amount with you and we'll true it up every year. But we want to be able to really invest behind what that overall platform is and I don't want to get tied up in procurement every time you launch a new feature and I want to add it on.

I think that's really exciting. There are very few companies that have the breadth of products to be able to get that from their customers. I think that the fact that our customers are pulling us in that direction and asking us for those types of licenses speaks really well for the future of our business.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

And, Jim, what I would add is that we have always been really well-diversified. So even if you go back to our S-1 at the IPO, you could see that the representation across all critical verticals was really, really strong. And even in a quarter like the fourth quarter, there was no one customer larger than 5% of revenue. What you see is that we are more successful landing new big logos because all the product and feature strength that Matthew mentioned,

but that we are able to accelerate revenue with the existing customers in those verticals and that is reflected in our DNR.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Helpful, guys. Thanks again.

Operator: Your next question comes from the line of Keith Weiss with Morgan Stanley. Your line is now open.

Keith Weiss

Analyst, Morgan Stanley & Co. LLC

Q

Excellent. Thank you, guys, and congratulations on a great quarter and a great year.

I wanted to dig in a little bit to kind of – I see what Matthew Hedberg was asking. Any way you could give us sort of more of a sense or sort of more tangible sense of what the major revenue contributors were to this quarter and sort of to that strength? And to what degree, I mean, ideally like a percentage of revenue, what degree is stuff like Cloudflare One and the Workers product significant contributors to that revenue outperformance today versus being kind of the forward items of growth? Because it sounds like they're really starting to contribute [ph] on that (00:43:23). And then I have a follow-up question for Thomas.

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Sure, Keith. So, first of all, I think when we talk about Cloudflare One, Cloudflare One is really a collection of a number of our different products. It is saying, how can you use not just WAF, not just DDoS, not just CDN, not just our access or gateway products, but how can you use those all together in order to build what is sort of the ideal future corporate network? And so what we see is customers are buying into that vision, and when they ask for using the broader set of our platform.

And so I think that what we're excited by is that more and more customers are using the broader set of our platform. That's great. What we're also equally excited by is there are very few that have fully bought into the entire vision, and that sometimes they don't buy the vision. They actually are super excited about that vision. But it's just that we keep announcing new products and releasing new things, and that gives us the opportunity to sell more to those existing customers. And I think that that's why you've seen, over the course of the last year, our dollar-based net retention continued to tick up, is that we have just done a great job at selling more to that existing customer base. I think something like Workers again, I think it's hard for us to break out how much of a sale it's responsible for because it does end up in a bunch of different deals as a way to give us the flexibility and programmability to win those deals.

What we are seeing independently is that we're starting to see a real uptick in people who are using sort of just Workers and that they are starting to generate meaningful build just from using the Workers platform itself. But it is still, I think, something that we think of that sort of act one was the CDN, WAF, DDoS, DNS, those types of products. Act two is our Zero Trust product, which I think we're square in the middle of and where a lot of our growth is coming from. I think act three is Workers, and that still I don't think has hit really the hockey stick sort of point in the growth curve.

Keith Weiss

Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's super helpful, Matthew. I really appreciate that. And then, Thomas, you talked about network CapEx expanding as a percentage of revenues, which is on top of base revenues, are obviously growing very fast next year. Can you help us understand how much of that is into like the core kind of network capacity, if you will? And is there a pickup that's associated with some of the newer initiatives, if you will, like is offices having an impact there or R2 going GA? Is that having an impact on the level of CapEx?

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

So, I think the first answer is that if you go back over the last five years, we have rather consistently spent about 11% to 12% of revenue for network traffic. So, the new guidance is 12% to 14%. It's a slight uptick. There is only a modest amount of R2 investment in this number. And you heard it already from Matthew, the ability of our business model that we can invest behind [indiscernible] (00:46:54) talking about this for a while on the go-to-market side, is also true for products like Cloudflare for offices. We don't invest free in idle capacity and hope that we fill it over time. So, we follow demand expansion with existing customers, as you heard from Matthew, is the first priority. So, there is little investment in this guidance that is ahead of demand that we hope we'd generate. There's very little at this point for R2 and offices because we can follow demand. So, it's more about getting the core capacity to where it needs to be, and making sure that we move the network further out closer to the eyeballs we want to connect and also be thoughtful about some large strategic customers that are moving business our way that we are now prepared for that.

Keith Weiss

Analyst, Morgan Stanley & Co. LLC

Q

Got it. Excellent. Thank you so much, guys.

Operator: Your next question comes from the line of Shaul Eyal with Cowen and Company. Your line is now open.

Shaul Eyal

Analyst, Cowen and Company, LLC

Q

Thank you. Good afternoon, guys. Congrats on the ongoing strong performance. Also, thanks for the transparency on large customers' metrics. I was about to ask both Matt Hedberg's and Keith questions also from a different direction, but I get the point, Matthew.

Maybe from a different perspective, you called out some Workers' wins and the displacements this quarter. Can you, Matthew, provide us maybe with some more color who is it that that you have been, that you are displacing in recent months with that product?

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. I think that there are sort of two different directions that that product displaces. So, the first is for some users, what they use Workers for is to make our products the most configurable version in the world. So, if you want the most configurable firewall or the most configurable DDoS mitigation service or the most configurable DNS service, Workers is a way to extend those services to make them highly programmable and highly configurable. And so I think there are a number of what we would think of as point cloud solution. People who are in the DNS or DDoS or CDN or WAF, a firewall space, that Workers allows us to help make our platform do exactly what they always dreamed and wished that their platforms could do. And that, I think, is, especially for larger and larger customers, something that is really just catnip and makes them extremely excited for using us.

I think the other place where we see a lot of displacement, which is sort of a different type of use case and probably the one that is more exciting over the long term is people who are moving away from other traditional public cloud vendors. What we see is that, first of all, the public cloud is moving from a world where you're effectively renting a VM on a box somewhere and you had to manage the operating system and the software and everything else to what is a much more managed, what is known in the industry as a serverless platform.

And I think when you look out – you talk to developers, Workers is one of the serverless platforms that they are the most excited about. And so we see regular win head-to-head with – competing with sort of an AWS Lambda or a Google or Microsoft Cloud function. Those types of services we compete really well on. And we try and compete on all of the different factors that matter: On performance obviously, but actually that's the least important of that. Consistency and reliability, which we do a great job because our cold start. We have literally zero millisecond cold start time. The ability for us to be extremely cost effective. And if you do a head-to-head comparison with Workers running the same workload versus the public cloud, even with the margins that we have, we're extremely cost competitive because it's just a better architecture of how we've designed it. Ease of use, making it really easy, and I think that there has been, over Q4, some really incredible developments, and you're going to see more over the coming quarter, and us really just making Workers the easiest to use serverless platform that's out there.

And then as Thomas referenced, I think we're increasingly seeing more and more especially large sophisticated customers who, because of government and regulatory requirements around data localization and data sovereignty, that they need to store and process data locally. And the fact that we can say, more than 100 countries around the world, we can keep your users data in their home country, not only to be stored there, but actually processed there, that's something that no other cloud provider can compete with. And so if that's something that from a regulatory perspective is important to you, those are deals that we are winning more and more.

So, we're excited about the adoption of Workers. Again, I think it's sort of a two-trick pony. It is both really, really good at being able to help us make all of our existing products as configurable as possible. But then it is also extremely good as a true cloud computing platform that developers are building entire businesses on.

Shaul Eyal

Analyst, Cowen and Company, LLC

Q

Understood. Understood. Thank you for the great color. And maybe can you talk about your plans to set up new points of presence then in 2022 as, without a doubt as we're seeing, the network keeps expanding fairly quickly. So, maybe you can quantify how many PoPs you think about establishing this year.

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

So, I have to confess, I hate the term PoP because I think that no normal people know what it means, and it's not even how we really think about the world. What we are trying to do is directly interconnect with as many networks around the world as possible. And so you can turn up a whole bunch of PoPs, but if they're not connected to networks, they don't give you any real benefit.

So, we have traditionally talked about the cities that we are in, and we continue to expand that. What we have not done, because again it doesn't really matter to our customers, is break down within those cities how many individual facilities we're in. What we are in most major cities now is in multiple different facilities. In certain cities now, we'll have multiple individual availability zones in order to make sure that we have a high degree of

availability. But we are continuing to go into more and more networks around the world, and I think that we're on track to be in every US state before the end of the year. I think that we continue to be in the vast majority of major cities, with over 2 million people in them, and we continue to invest in getting connected to all of the networks in the world.

What's unique about us is that we continue to have it so that every day our phone rings with network providers around the world who are inviting us to be directly in their networks. And that's unique, and it's unique because of the broad set of services we provide, the broad set of customers that we have. And I think that that is part of what explains how we've been able to achieve and maintain and actually improve on our gross margins, even as our traffic rate have continued to increase, and that's really differentiated from anyone else in the space.

Shaul Eyal

Analyst, Cowen and Company, LLC

Q

Sure, sure. Matthew, thank you so much. Keep up the great job.

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Thank you.

Operator: Your next question comes from the line of Sterling Auty with JPMorgan. Your line is now open.

Sterling Auty

Analyst, JPMorgan Securities LLC

Q

Yeah. Thanks. Hi, guys. I'm just going to ask one question. Matthew, you gave the example of the Fortune 500 pharmaceutical company network security win worth about \$750,000. When I think about a Fortune 500 company, I usually think about them spending tens of millions of dollars on firewalls, for example. So, what I'm wondering is, is the opportunity when you go in and replace those physical appliance, is that a fraction of the spend that those customers need to make or you're just so early that this is just the very tiny beginning in terms of that opportunity with a customer like that?

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

I think we're super early. I think that we are going to continue to be able – what we have seen with customers is that we typically win with deals and then are able to expand them over time as they adopt more and more of our platform. We don't ask people – one of Thomas' favorite points to remind me to bring out is that we're not a rip-and-replace solution. We are happy to go in and put ourselves in the mix with other firewall vendors and be very complementary to them over time or load balancers or WAN optimizer, whatever it is. And what often will happen is a customer will say to us, listen, our existing network is working okay for us, but we've got this far flung office that we need to take care of. We're worried about contractors, and we want to keep them separate from the rest of our network. Maybe you can help us with that. What then tends to happen is they have such a good experience with that that they see that as a replacement time is coming up on their hardware equipment, that they say, well, maybe we can just replace that with Cloudflare, and over time we win that war of attrition.

I think there were really two kind of head fake for the hardware business over the last four years. One was the Trump tax cuts that really incentivize moving forward CapEx spend and probably kind of artificially buoyed some of the hardware manufacturers that are out there. And the second was really COVID, where people weren't – they may have planned on moving to a Zero Trust architecture, moving to a cloud architecture, but when COVID hit,

they were like, all bets are off, I'm going to buy just more of whatever I have right now, and I think that that was a little bit of a head fake for some of the hardware space.

What we're seeing, though, is that as people are coming out, as IT organizations are seeing sort of a light at the end of the COVID tunnel, they're saying, we – now it's time for us to go back and actually invest in what we think of as the long-term architecture. And increasingly, what we hear from the largest customers in the world and an industry analyst is that what it is that we're building is that future of the corporate network, and I think more and more customers are going to continue to expand over time, and including that pharmaceutical company.

Sterling Auty

Analyst, JPMorgan Securities LLC

Q

Understood. Thank you.

Jayson A. Noland

Head-Investor Relations, Cloudflare, Inc.

A

Emma, can we take one more analyst, please?

Operator: Excellent. Your last question comes from the line of Amit Daryanani. Your line is now open.

Amit Daryanani

Analyst, Evercore Group LLC

Q

Perfect. Thanks for squeezing me in. I [indiscernible] (00:59:01) one question as well. Last quarter, there was a fair bit of talk around the R2 offer, which is something going to get ready for GA soon. Can you just talk about what has the customer feedback been for R2 in the last 90 days? And I think since you started talking about it, AWS did lower their previous peaks a fair amount, so [indiscernible] (00:59:19) in your perspective as well.

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Well, actually I didn't lower their egress fees all that much. But I am flattered that they're paying attention, and I think they have a long way to go in order to catch up with the rest of the industry. I think the leaders in the space actually have been folks like Oracle and Google who have said that they will have much more dramatic egress lowering, and I think it's only a matter of time before AWS will follow that as well. And if we can be a part of catalyzing that for the industry, I think that that's a huge win.

What we heard though from the feedback on R2 has been terrific. So, we've been running it in a private beta. We've had customers on board. They have given great feedback on the places that it's working extremely well. What we're optimizing right now is just making sure that we have exactly the same performance characteristics that we would expect and that customers expect from S3. And we think that they architecturally will be able to meet or beat that over time.

We're excited by our ability to deliver this. I'm looking forward to the day that I can share the logos of who I'm talking about bringing data over, but we have hundreds of petabytes of data that we are confident we'll, as R2 goes GA, be able to move over to our platform. And I think that, again, it's exciting for the revenue that that will generate. But what I think it's really exciting for is two other things; that it really will help catalyze our overall Cloudflare Workers' growth and it becomes a fundamental component of that computing platform. But then secondly, that it's going to help unlock the cloud because I think that other cloud providers will have to respond to this, and it is a win for the entire industry if we're able to drive what [indiscernible] (01:01:17) egregious egress

fees down. And what we want to make sure is that customers can choose products based on whoever is the best out there, and we are confident that we've got a platform that can win on the performance, security, reliability and cost side. And that's, I think – I'm excited for how we are positioned to be delivering on our value proposition going forward. And our entire team, I'm proud of – for what they've built. And that we've got AWS to blink a little is that – it's something that I think is good for the entire industry.

Amit Daryanani

Analyst, Evercore Group LLC



Absolutely. Perfect. Thanks a lot for your time.

Operator: This concludes today's Q&A session. I now turn the call back over to the company for closing remarks.

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

Thank you so much to everyone for tuning in to the earnings call. As I said at the beginning, it has been a most excellent quarter for us. There's a ton of hard work that goes in behind the scenes to not just get ready for these earnings calls, but more importantly service our customers, build great products, and deliver on the value of our mission, which is to help build a better Internet.

And so I just wanted to thank everyone of our customers, every one of our investors, and most importantly every one of our employees for what was an incredible Q4 and an incredible year. We're already hard at work in 2022, and we look forward to tuning in to give you the updates on what we did in Q1. Thank you so much.

Operator: This concludes today's conference call. Thank you for attending. You may now disconnect.

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